An Overview of State Bond Debt

Background

What Is Bond Financing? Bond financing is a type of long-term borrowing that the state uses to raise money for various purposes. The state obtains this money by selling bonds to investors. In exchange, it agrees to repay this money, with interest, according to a specified schedule.

Why Are Bonds Used? The state has traditionally used bonds to finance major capital outlay projects such as roads, educational facilities, prisons, parks, water projects, and office buildings (that is, public infrastructure-related projects). This is done mainly because these facilities provide services over many years, their large dollar costs can be difficult to pay for all at once, and the different taxpayers who pay off the bonds benefit over time from the facilities. Bonds also have been used to help finance certain private infrastructure, such as housing.

What Types of Bonds Does the State Sell? The state sells three major types of bonds to finance projects. These are:

- ***General Obligation Bonds.*** Most of these are directly paid off from the state's General Fund, which is largely supported by tax revenues. Some, however, are paid for by designated revenue sources, with the General Fund only providing back-up support in the event the revenues fall short. (An example is the Cal-Vet program, under which bonds are issued to provide home loans to veterans and are paid off using veterans' mortgage payments.) General obligation bonds must be approved by the voters and their repayment is guaranteed by the state's general taxing power.
- ***Lease-Revenue Bonds.*** These bonds are paid off from lease payments (primarily financed from the General Fund) by state agencies using the facilities the bonds finance. These bonds do not require voter approval and are not guaranteed by the state's general taxing power. As a result, they have somewhat higher interest costs than general obligation bonds.
- ***Traditional Revenue Bonds.*** These also finance capital projects but are not supported by the General Fund. Rather, they are paid off from a designated revenue stream generated by the projects they finance—such as bridge tolls. These bonds also are not guaranteed by the state's general taxing power and do not require voter approval.

Budget-Related Bonds. Recently, the state has also used bond financing to help close major shortfalls in its General Fund budget. In March 2004, the voters approved Proposition 57, authorizing $15 billion in general obligation bonds to help pay off the state's accumulated budget deficit and other obligations. Of this amount, $11.3 billion was raised through bond sales in May and June of 2004, and the remaining available authorizations were sold in February 2008. These bonds will be paid off over the next several years. They are excluded from the remainder of this discussion, which focuses on infrastructure-related bonds.

What Are the Direct Costs of Bond Financing? The state's cost for using bonds depends primarily on the amount sold, their interest rates, the time period over which they are repaid, and their maturity structure. For example, the most recently sold general obligation bonds will be paid off over a 30-year period with fairly level annual payments. Assuming that a bond issue carries a tax-exempt interest rate of 5 percent, the cost of paying it off with level payments over 30 years is close to $2 for each dollar borrowed—$1 for the amount borrowed and close to $1 for interest. This cost, however, is spread over the entire 30-year period, so the cost after adjusting for inflation is considerably less—about $1.30 for each $1 borrowed.

Source: Legislative Analyst's Office